MACROECONOMIC AND MONETARY ISSUES

ISSUE

NSC review completed

There are four broad areas of tension between the U.S. and its major allies on macroeconomic and monetary issues:

1. Exchange market intervention policy
2. U.S. economic policy mix (mostly the budget)
3. High interest rates
4. The Japanese trade surplus

We have had extensive, very candid discussions with our European, Canadian, and Japanese counterparts on all these issues, and while we are obviously not in total agreement, there has been progress. The United States has developed well-reasoned substantive positions to address each of these, and steps are underway to deal with our differences.

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BACKGROUND

1. Exchange Market Intervention Policy

EC Position. Our allies (not just the EC) believe we should intervene more frequently in foreign exchange markets. Most of them believe that official intervention can help to dampen exchange rate volatility. At a minimum, foreign officials feel that intervention should not be renounced as a policy tool. In this regard, they were concerned that markets had misinterpreted current U.S. policy as one of total unwillingness to intervene under any circumstances. We have worked hard to dispel this impression during the past few months, through repeated private and public statements that while our policy is not to intervene under normal circumstances, we always stand ready to do so if necessary when markets are disorderly. The fact that we actually intervened on June 14, in the wake of the realignment of the European Monetary System (EMS) and widespread political uncertainties elsewhere, helped to lessen this source of tension with our allies.

Nonetheless, serious differences of opinion remain. Most of our allies would still prefer a more active U.S. intervention policy, and some would even like joint intervention to help peg exchange rate levels (especially the French).

U.S. Position and Rationale. Our policy is to intervene in foreign exchange markets only if necessary to counter disorderly markets. This policy is in full compliance with our obligations under the Articles of Agreement of the International Monetary Fund. In practice it has led us to intervene only twice since February, 1981. Under normal circumstances we believe that intervention is at best pointless, and perhaps even harmful, for three main reasons:

-- Foreign exchange markets are large and efficient, and make full use of all available information in arriving at a collective "judgment" about where exchange rates should be. We do not believe any government or individual can second-guess the markets.

-- Intervention to fix or manage exchange rates has not succeeded in the past, and there is no reason to believe it would do so now. Market forces cannot be disguised for long. We should recall that frequent and massive intervention during the late 1970s did not keep rates from moving in the very directions that intervention was trying to avoid.

-- Because they believe they can buy time through intervention, governments sometimes delay needed domestic policy changes far too long. In addition, governments in strong economies which intervene against their own currencies may sacrifice domestic policy discipline and worsen their own inflation performance.

There is only one way to get fundamental stability in exchange markets, and that is through greater convergence in the domestic economic policies and performance of the major trading nations. As long as some countries have high inflation rates, and run generally unstable and undisciplined economic policies, there is simply no way to keep their currencies from depreciating relative to countries with stronger economies. Only when all are moving toward stable, non-inflationary economic policies and performance can we expect more stable exchange markets.

The EC is far from blameless in this matter. The French are the greatest critics of U.S. intervention policy, but the franc is a weak currency in the EMS principally as a result of Mitterrand government policies. Poor French inflation performance, policies and prospects have made the franc the weakest of the major European currencies. Other EC countries, like Italy and Belgium, have let their budgets go totally out of control. At times participants in the EMS have vainly tried to impose stable exchange rates among the EC currencies through intervention, while letting underlying economic policies and performance drift apart.

Not only have we taken great pains to overcome misconceptions about our intervention policy, but we have also set in motion two major procedural initiatives to help deal with the major issues. First, and in our view potentially most important, is the process of enhanced consultation on relative medium-term economic policies of the major countries, outlined in the Versailles Summit "Monetary Statement." In response to a U.S. initiative, the leaders of the major industrial countries agreed at Versailles that individual success in the fight against inflation is a precondition for a durable economic recovery. They recognized that exchange market stability stems from stable, non-inflationary domestic policies, and agreed to work together in cooperation with the International Monetary Fund to hasten the convergence of economic policies and performance among them. Preparatory work to establish procedures for this process is now underway, and we expect to have the first full meeting of the group at Ministerial level in September.

As a complement to this, the other major governments agreed just before the Summit to join us in a thorough multilateral study of the impact of past exchange market intervention. Preparations for this study are being worked out by an experts group, which met in mid-June in Paris and in early July here in Washington. Two additional meetings are scheduled for late July and early September. We expect a Ministers meeting in Toronto to approve a definite terms of reference and timetable for the study.

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2. U.S. Economic Policy Mix (Budget Deficit)

EC Position. At times, most foreign governments have complained that an alleged U.S. "policy mix" of tight monetary policy and loose fiscal policy is forcing our "real" interest rates (nominal interest rates adjusted for inflation expectations) to be unnecessarily high, which in turn forces their own interest rates up. Over time, most have realized that there is no acceptable alternative to a non-inflationary monetary policy, so the focus of their complaints has shifted to the U.S. budget. They argue that our current and prospective budget deficits are the major reason for our high real interest rates. They suggest that we should reverse or defer the scheduled tax cuts and slow the growth of military spending in order to reduce the deficit more rapidly.

U.S. Position and Rationale. While the budget deficit is a problem, the deficit in itself is not the only reason for high real interest rates. Our basic problems have been the lack of discipline in government spending and the variability of money growth. These two factors contribute to the lingering uncertainty that inflation will be kept under control (see also "High Interest Rates" below).

As a general matter, we believe that incentive-oriented tax rate reductions are an essential component of the President's program for sustainable non-inflationary economic recovery. Similarly, one of the government's primary responsibilities is to provide a strong national defense. While a number of factors are adding to the budget deficit, including the prolonged weakness of the economy, our unexpectedly rapid progress in cutting the inflation rate, and inadequate control of non-defense expenditures, the answer is not to change our basic tax and defense policies and abandon a stable policy course. Rather, we will be working aggressively with Congress to reduce the budget deficit in FY 1983 and beyond. The recent budget compromise is the first step in this process.

The most important thing we can do in this area, for domestic as well as international reasons, is to continue to press for expenditure restraint and less volatile money growth. In the meanwhile, foreign officials will have a chance to review our efforts and discuss them with us in bilateral and multilateral consultations, especially the enhanced consultation process endorsed at Versailles.

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3. High Interest Rates

EC Position. Europeans believe that whatever the reason for unprecedentedly high "real" U.S. interest rates, there is no hope for vigorous economic recovery anywhere in the world until we get our interest rates down. They argue that because of the dominant role of the U.S. dollar in world financial markets, high U.S. real interest rates automatically push other countries' interest rates up as well. The result is worldwide economic stagnation and rising unemployment.

They would like for the United States to do "whatever it takes" to get our interest rates down. The most widespread prescription is that we should move faster to cut the projected government budget deficits (see "Policy Mix" above). Some also believe it would be possible to lower real interest rates by targeting monetary policy less on slowing the growth of the money supply, and more on stabilizing interest rates.

U.S. Position and Rationale. We, too, are being harmed by our high real interest rates. Our stake in getting them down is at least as great as that of any of our allies. U.S. interest rates are already well below their peaks, and we remain convinced that interest rates will come down further if we persevere in implementing the President's basic program for economic recovery. We are of course disappointed that it is taking so long to happen, and consider this the major short-term uncertainty in the economic outlook.

We should note, however, that interest rates are high abroad for domestic reasons, not just due to passive responses to high real interest rates in the United States. This is especially true of the unusually high rates now prevailing such countries as France, Italy, and Belgium as a result of their very poor inflation peformance and weak economic policies.

While it is difficult to explain fully the persistence of high U.S. interest rates in the face of our declining inflation rate, there seem to be a number of contributing factors. The budget deficit is clearly one of them -- particularly the uncertainty surrounding the impact of unrestrained government spending on the budget situation in future years. In addition, the Federal Reserve has had difficulty in keeping near its target growth path for the monetary aggregates, raising concern about the ultimate direction of monetary policy and thus of inflation. Market reactions to the volatility of money growth have added several percentage points to the level of interest rates.

We must continue our efforts on both of these fronts. We should keep up pressure on the Congress to enact the measures needed to bring government spending under control. We must certainly stick to the fight against inflation. While there has been a dramatic improvement in underlying U.S. inflation performance over the past year, inflation expectations are lagging behind because our citizens are not sure we can stick to our guns. The faster we can convince them that we are going to bring inflation permanently under control, the faster we can reduce the "uncertainty premium" in interest rates.

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On the monetary policy front, we fully support the stated Federal Reserve policy of achieving a gradual reduction in the growth rate of the money supply. However, while the Fed has on balance given us slower money growth, the growth path has been erratic: performance has not matched intentions. As a result, interest rates have been much higher than would have been the case with steady, stable, and predictable money growth. We believe that a smooth and steady reduction in the growth rate of the money supply is essential to our efforts to reach a sustainable non-inflationary economic recovery. We know the Fed is sincere, and we are hoping that it will improve the implementation of monetary policy. One positive sign that the volatility of money growth might be reduced is the Fed's recent decision to approve in principle one of the technical changes this Administration has been urging them to adopt -- contemporaneous reserve accounting. While we believe that some other technical changes are also needed, this decision to shorten the lag in bank reporting to the Fed from two weeks to two days could help increase the Fed's ability to control the money supply.

Obviously the complaints by our allies, including the EC, about high U.S. real interest rates will persist until we are successful in bringing them down. Our best method of dealing with their complaints is to continue being candid with them about our own concerns on this score, to express sympathy for their difficulties, and to emphasize the measures we are taking to remedy the situation. Again, the Versailles Summit "consultation group" should provide a forum for thorough discussion which will help clear the air.

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4. The Japanese Trade Surplus

EC Position. There is concern, both in Europe and the U.S., over the growing Japanese trade surplus. The Japanese have become extremely successful competitors in a number of large and politically sensitive industries, including automobiles, electronic appliances, and semiconductors. Some observers have argued that the Japanese have "artificial" advantages, caused by relatively low Japanese interest rates and an "undervalued" yen exchange rate which makes their exports unreasonably cheap on foreign markets. Some believe that the Japanese should change their economic policy mix -- easing fiscal policy and tightening monetary policy (i.e. the reverse of what they want the U.S. to do). They argue that this would lead to both faster growth and higher interest rates in Japan -- and that these in turn would cause the yen to strengthen on exchange markets. Others believe that the Japanese should institute capital controls to strengthen the yen.

U.S. Position and Rationale. Japanese interest rates are low as a result of their consistently successful economic policies, and the good Japanese track record on inflation. We feel it would be highly inappropriate to press the Japanese to run bigger budget deficits at a time when their deficit is already quite large in terms of GNP. We have no evidence that the Japanese are artificially depressing the yen exchange rate. In fact, it is clear that Japanese officials would like to see a stronger yen, but have not found an acceptable way of bringing this about. We have a long-standing objective of getting the Japanese to open their capital markets more to foreign participation -- a goal which is inconsistent with the imposition of new capital controls (and whose achievement might, at least in the short run, tend to put downward pressure on the yen). We should avoid becoming a party to proposals for new Japanese capital controls or a weakening of Japanese economic policy.

We believe that the Japanese can best ease tensions with the rest of the world by moving vigorously to open further their markets for imports (as well as their capital markets). The Japanese government recently announced a package of measures to further liberalize market access, which we greeted with cautious approval. These are a step in the right direction, but we are pressing them on both the follow-up and possible additional measures.

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